

Comments before Assembly Committees on Revenue and Taxation; and Jobs, Economic Development, and the Economy

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What role should tax expenditure programs play in the California budget process?

In the upcoming fiscal year, and foreseeable future fiscal years, the California Legislature faces significant budget constraints.

Of perhaps greatest importance is eliminating the current \$8 billion structural deficit; in attacking this problem, it is important to recognize that the State “spends” without spending.

A quick example could be that the Legislature desires more qualified teachers in the State’s underperforming urban school districts. This can be achieved by raising take home pay of teachers who choose to work in this environment. One way to do this is through legislation, taken through the appropriations process, which allocates state funds for higher pay for teachers willing to work in such situations. Legislators and the public realize that this would require additional state revenue or the reduction of a currently funded program. An alternative would be to exempt the pay of teachers who choose to work in such a situation from state income taxes. This alternative requires no direct expenditure to put through the appropriations process, but is a tax expenditure.

Tax expenditure: a deviation from “normal” tax structure that results in a revenue loss and requires additional state revenue or expenditure cuts to make up for it.

Legislators crafting the State’s budget would definitely benefit from knowing the price in lost revenue that each of California’s tax expenditure programs entail.

Let me describe an economic evaluation process by which the dollar costs of tax expenditures could be used to make more socially beneficial budget decisions.

Assume that the California Legislature is looking for \$1 billion it must cut out of the State’s budget. The creation of a new tax instrument or the raising of statutory rates on an existing tax instrument is off the table for consideration.

The best way to go about this undesirable - from the perspective of a Legislator - task, is to consider all feasible cuts in both regular expenditures and tax expenditures.

Such consideration is ideally done in an incremental fashion.

Realize that the “benefit” of a \$ cut in a tax expenditure program, or a \$ cut in a regular expenditure program is equivalent and yields a \$ in needed deficit reduction.

The goal therefore is to minimize the “costs” that these cuts impose upon the citizens and business of California.

Thus, take a workable value of say \$10 million, and calculate the impact that cutting this amount of expenditure out of a specific program will cost the state in human suffering, economic development, job losses, future productivity, etc. Do such calculations for all possible \$10 million dollar cuts in different state programs.

Then perform the same type of calculation of the cost to the state in eliminating \$10 million dollars in a tax expenditure program for a specific instance it is being used. Make these calculations for all separate instances of tax expenditure programs.

Once the costs of cutting different direct expenditure and tax expenditure programs are known, the first thing that should be cut is the one that yields the least cost to the state with no regard as to whether it is a direct or tax expenditure.

If a direct expenditure or tax expenditure program is cut by \$10 million, then there is a new need to calculate the cost to state of cutting the program by an additional \$10 million. This new cost is then placed in the list of costs to consider.

In the next round, again choose the direct or tax expenditure cut that yields the least incremental cost to citizens and business in California.

If this incremental process is done 100 times, at a \$10 million cut each time, it will yield \$1 billion in deficit reduction that is guaranteed to produce the lowest overall cost to the state to achieve this needed benefit.

Note that such a desirable budget decision process is only possible if there are known values for all tax expenditure programs in the state, and an analysis and discussion occurs of exactly what are the “benefits” being produced through these tax breaks. The loss of these benefits (through the proposed \$10 million cuts) then becomes the costs to the state of eliminating them.

Wouldn't it be more honest to take tax expenditures out of hiding and put a price tag on them? We would then know how much each business and social policy that is embedded in California's tax code costs us. We would then be more inclined to preserve the ones that are yielding a payoff worth more than what they cost the state in lost revenue and eliminate the ones whose benefits are not worth the costs.